UBS EUROPEAN CONFERENCE WITH WILLIAM CHALMERS, LLOYDS BANKING GROUP – TRANSCRIPT
(amended in places to improve readability only)

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William Chalmers, Chief Financial Officer
Jason Napier, Head of European Banks Research, UBS (moderator)

Jason Napier
Good morning everyone and welcome to the Empire Room. It's my pleasure to welcome William Chalmers, who is the Finance Director of Lloyds Banking Group. As you know, the biggest bank in the land. William has been CFO there for four years, although I'm sure there are days when it feels like more, but it's a great pleasure to have him with us today. As those of you who follow the banks will know, it's been a tough year for domestic UK banking stocks. There have been some negative surprises in the outlook for net interest income in particular in the last couple of quarters. And Lloyds stands out as having shown a far more resilient picture on net interest income, and so it would be crazy to start anywhere else than that picture. So first of all, William, thank you for joining us today.

William Chalmers
Pleasure, thank you Jason.

Jason Napier
Can we talk about net interest income?

William Chalmers
Of course.

Jason Napier
Before I get into what might make Lloyds different, if you could just talk about the big factors that have been impacting this year, please. And give us a sense as to how those evolve in strength terms as we go into next year.

William Chalmers
Happy to, Jason. Again, thank you for joining. And those in the audience, thank you for taking time. The guidance for 2023 as you know is greater than 310 basis points for the net interest margin, which we restated and reconfirmed at Q3. That implies just over 300 basis points for Q4. And then in turn, that's about a six to seven basis point drop versus the 308 basis points that we saw in Q3.

So looking forward, Jason, to answer your question, the dynamics that we saw in Q3, we would expect to more or less play out going into Q4 and then again into 2024. So specifically on those, within deposits, we actually had a decent performance in deposits in Q3, up about £0.5 billion. But within that headline number, there was churn from PCAs into savings for example. And then within savings, from instant access into fixed term. It would surprise me frankly if, given the rate environment that we're in, if that doesn't continue in Q4. And indeed, we think it will continue into 2024. But over time I would expect that to taper a little. It'll be because of the absence of bank base rate prompts that we've seen during the course of this year. It'll be because the money that is going to move, by and large, probably has moved or it's in danger of missing out, if you like, on peak rates. And it's also in the context of forward rates coming down and therefore most probably fixed term offers coming down with that, alongside a convergence of instant access rates somewhat closer to fixed term.

So this deposit churn pattern continues to Q4 and into 2024, but we do think it starts to taper most likely at some point during next year. Although being too precise as to when, that's harder. Alongside of that, the other major headwind is the mortgage refinancing. Now the mortgage refinancing is very mechanical. At the moment, we've got about 175 basis point spreads in mortgages rolling off onto about 50 basis point spreads in mortgages. As we go through '24, those spreads that are refinancing off start to come down, and gradually realign themselves with the front book spreads within mortgages. By the time you get to mid '25, that is pretty much taken care of. That mortgage headwind is pretty much eliminated by around the midpoint of 2025.

And then the major tailwind, as you know, is the structural hedge. And that's a powerful tailwind. At the moment, structural hedge is yielding about 1.35 per cent. For every derivative that comes off the structural hedge, it is refinancing into a 4 to 4.5 per cent environment, so a significant tailwind there. For 2024 however, it is somewhat backend loaded in its overall complexion. What that means is that, for the net interest margin as a whole, given those

puts and takes, Jason, you're seeing a picture of most likely continued net interest margin pressure in Q4 as I indicated. That continues into 2024. And then at some point next year I would expect it to start to pick up, and via the benefit of the structural hedge, go in the other direction during the course of the year. Again, I wouldn't want to put too finer point on precisely when. We'll talk a bit more about that at the year-end.

There's one other point which I'll, if you don't mind, just take advantage of, is when you look at our net interest income, don't just look at the net interest margin, also look at non-banking net interest income, which is essentially the interest expense that we use to finance our other income activities. There are two points in that. One is obviously in a higher rate environment, that net interest expense will go up. And then second is, as you know, our other income activities have been growing. And so there's a volume effect there too. So when you look at that item, bear in mind that it's likely to go up in Q4, it's likely to also go up in 2024. And when you bring together therefore net interest income expectations, put that into the equation too.

Jason Napier
All right. That's helpful, really helpful. So in Q3, just looking at history, a margin down about six basis points, that's about a third of what your two largest listed peers turned in. I mean is there anything you can say without wishing to have you talk about other people's businesses about the market as a whole? Is it rational that you'd be very different over perhaps a longer period of time? Is it just a timing thing?

William Chalmers
As you say, Jason, it's hard for me to comment too much on peers. I can comment on our own performance. I think in the context of our performance during third quarter, your particular comment maybe relates to liability side of the equation, deposit performance in particular.

We saw within that as said, around a £0.5 billion growth within deposits. But to be clear, we did see churn within the overall deposit base. Again, PCAs into savings, and within savings into fixed term. Why did we fare the way that we did? I suppose a couple of points that I would make really. One is it's a broad demographic from a customer base point of view. So you're getting all sorts of different customers within that overall mix. Two is we have a very proactive customer outreach program. So we've contacted for example, well over 10 million customers in terms of making product recommendations to them, which hopefully makes sense from their point of view whether they prefer yield or whether they prefer access or whether they prefer distribution.

And that leads into the third point, which is that we've got a pretty broad product set. And it is designed, if you like, to really cater to all tastes. So if you look at the instant access products we've got, whether they're PCAs or whether they're instant access savings, different types of products for different types of customer needs. Alongside that, when you look at individuals who want to lock up their savings for longer, fixed term products but also limited withdrawal, which in turn is a product that allows, as the name suggests, limited withdrawals over a period of time, which suits some who want both access and yield.

And so Jason, I don't think there's anything particularly spectacular about what we're doing, but we do try to cater for different types of communities, different types of customer needs. We do try to ensure that all customers are aware of the products that we have. And that's manifested in things like PCA outflows being around two-thirds recaptured by our savings products. And I think overall the fact that deposits were up during the third quarter hopefully points to a relatively resilient franchise and a robust offering to our customers, Jason.

Jason Napier
Thank you. Now, when interest rates were zero for all that time, we became experts in mortgage spread analysis, because it was the only money being made effectively in the balance sheet. And although deposits are a big swing factor at the moment, mortgages are still a huge preoccupation. So for the longer term shareholders and potential shareholders we talk to who like to understand why mortgage spreads are as poor as they are, no one we talk to is happy with where the market is currently settled. What could we infer from the fact that none of the big players like where spreads are right now?

William Chalmers
It is a good question, Jason. I think the first point that I would infer or at least observe is where you opened up really, which is to say at all times keep an eye on the total spread from a bank point of view. So look at not just the asset spread at any given moment in time, but also the liability spread alongside of that, and I think that's an important start point.

Beyond that, the completion margins as you say, I mean it's pretty competitive right now. 50 basis points is what we saw in Q3. It's also what we saw in Q2. And I think it's probably also more or less what we'll see in Q4 too. So it seems to be, for the moment at least, settling at around that level, but it's a low and it's relatively competitive level. That in turn I think reflects a combination of blending of two margins. One is product transfer margin, which is right now where the bulk of business is coming from. And that is a margin that is below 50 basis points to be clear. But on the other hand, we know the credit that we're lending into there, it's an existing customer relationship.

The other side of the margin is a new business margin, which is in excess of 50 basis points, which represents a growth opportunity. But of course the trouble is right now that there isn't much of it around. And so given that relatively scarce supply of new business, everybody is competing hard to maintain their market position. Nobody necessarily terribly much likes it, but when we look at the blended average of that 50 basis points, that means that we are still writing mortgages that is satisfactory from a cost of capital point of view. We'd love the spread to be higher, but at the moment, at least that level is at least clearing our cost of capital. And so it's not great, but we're okay to write mortgages at around that level.

I suspect that at some point, hopefully not too distant in the future, we see some normalization of new business levels. Most likely the market will get used to managing at higher rates, house prices will adjust to higher rates. And off the back of that, new business volumes will start to increase. And as they do, the volume effect of that in terms of the blended average that I mentioned earlier on plus also the kind of easing up of the competitive tension, I think, is likely to lead to a better overall completion margin for us and for other players, no doubt.

That will take time, but I wouldn't be surprised if it starts to pick up a little during the course of 2024. Having said that, two points. One is in the meantime for 2024 forecasts, we're projecting pretty modest volumes and pretty modest pricing. So we're not banking on, at Lloyds at least, on a kind of resuscitation of the mortgage market in that timeframe, albeit I do hope that we'll see the first signs of that. Then alongside, as you know, the strategy that we're developing is intending to build the customer relationship and relevance both within the mortgage product and also across ancillary and related products. And so, over time things like Home Hub in mortgages for example, the addition of things like protection, current accounts, GI products alongside the mortgage offering, they will both manage the cost base within the mortgage area and hopefully build customer relevance within the mortgage area, which in turn should allow us to offset tight margins.

Jason Napier
With other income?

William Chalmers
Yes.

Jason Napier
James von Moltke, the finance director of Deutsche Bank was sitting in that chair just before you. He was quite clear that change in deposit mix probably costs 500, 600 million of NI next year. Then it starts to grow again as the replication portfolio, their hedge book, comes back. I think you were quite clear earlier that you thought that margins would start to increase from a trough somewhere next year.

William Chalmers
Yes.

Jason Napier
I'm just wondering whether mechanically that doesn't end up in the same place that mortgage spreads ended up. It's a tailwind that could be invested in a more competitive market, but is it right that the view is that the hedge takes us to a higher level of revenues in '25? Is that something you could say?

William Chalmers
I think over time that is the picture. I mean, it's right to start off with the observation that it is a competitive market as you suggest, Jason. And we're seeing that play out in terms of various different product offerings. But again, it is important just to step back and look at the overall picture. And the overall picture right now is margins, we've said above 310 basis points during the course of this year. It's a relatively healthy margin. It leads to a relatively healthy RoTE. And indeed it leads to a relatively healthy, sustainable yield from an investor point of view.

I think looking at 2024, Jason, the comments that I made earlier on I think would hold, which is to say that I do expect margin pressure during Quarter 4 and going into 2024. I do expect the factors that I mentioned earlier on to play out and lead to some kind of revitalization of the margin as we go through 2024. We'll give guidance on when we think that might happen at the year-end, but that's the overall pattern during the course of the year. Now of course, if you average out that pattern leads to a margin that is below 300 for the year to be clear. But nonetheless, you've got that overall trend over the course of the year.

I think in terms of the hedge for 2024 and beyond at the moment, Jason, as you know, we've given guidance for about an 800 million tailwind from the hedge this year. We said that we expect a similar figure during the course of 2024, and we're sticking with that. That is coming from, again, a relatively mechanical rollover of the hedge from, again, a yield of around 1.35 right now into a yield that is more like 4, 4.5 or so.

I think then beyond, you asked about '25, without giving explicit guidance, the hedge tailwind potentially builds beyond then. It potentially builds beyond then as a result of two or three factors. One is the maturities that are coming up, and two is the locking in of pre-hedging that we have done in order to manage concentration risk around maturities of the overall hedge profile. So that in turn builds a profile into '25, but let's be clear, that depends upon prevailing interest rates at the time. And of course it depends upon depositor behaviour between now and then. So we won't be more precise than that, but hopefully it gives you a sense of the dynamics.

Jason Napier
It really does. One of the questions that I was going to ask, and you might be relieved to hear it's the last one on net interest income, was whether NIM can expand if rates are going down. You've produced a really quite nicely hedged NII line to date. Other banks have shown much stronger acceleration in their top line. Does that position you well to defend or even grow NIM if the Bank of England cuts? Does the hedge give you that sort of boost?

William Chalmers
Yeah, that's a good question.

Jason Napier
Can you generalise? I don't know.

William Chalmers
Well, one point that I'll make at the outset of that question is, in a way it's why we do the hedge. Your point illustrates why the hedge is valuable, because the hedge effectively allows us to protect income streams, which in turn allows us to protect distributions, well, capital generation and distributions to shareholders. That is a big part of what the hedge of course is about. Now it's also about protecting the regulatory capital position, which as you know, encourages stable earnings. And therefore if we didn't have the hedge, the volatility implied by that would probably imply a higher capital charge off the back of interest rate risk in the banking book. So the hedge serves both purposes, shareholder purposes, but also regulatory capital purposes.

When we look at the shape of the NIM profile, as you say potentially in the context of rates cuts next year, I think we're in fact forecasting a rate cut next year, second half of next year, in our base case economics. I think the important point is just to start from the comments that I made earlier on in terms of the net interest margin, Jason, for '24. So those comments hold for 2024, and just keep that in mind for '24. Then looking forward, the important rate for us is less the bank base rate at any given moment in time. It's more about the swap curve. And the swap curve, as you know, drives hedge refinancing, it drives mortgage pricing and it drives at least for the one year, two year type timeframe, deposit pricing as well, fixed term deposit pricing.

And so the forward curve is already pricing in rate cuts. So some of that is already built into our expectations for earnings. Just to elaborate a little bit on that, therefore the structural hedge current yield, again rolling off at 1.35, going on at 4 to 4.5, anything above 1.35 represents a tailwind for the structural hedge. So there's quite a lot of room for rate cuts and still getting a tailwind in the context of the structural hedge because of that dynamic. Beyond that, the overall margin then depends upon deposits, let's say, and depositor behaviour, and then of course asset margins. And just to elaborate a little bit on that, if we get into a rate cutting environment, then in turn that is very likely to affect fixed term pricing in the deposit market, which in turn is very likely to affect depositor behaviour, i.e, less churn. And so you might see in that context better performance in the context of non-interest bearing current accounts or in the context of instant access for example.

And then in mortgages, it's possible also that a declining rates environment stimulates the mortgage market, stimulates the housing market, to the extent that it's not already embodied in swap curves that is. And so again, that could lead to stronger new business flows, which in turn could lead to a slightly stronger overall completion margin per my earlier comments. So I think when you step back therefore, a falling rates environment does not necessarily dictate the margin environment. And the comments of 2024 hold, some of the comments I've made for 2025, hopefully give some guidance, but those are the factors that determine the outcome.

Jason Napier
That's helpful because I think it's observable that the sector, it's got a 16 per cent cost of equity implied in it. The market's saying that this is a classic cyclical over earning situation. And maybe the revenues are more stable than might be priced. The other thing, we've had two years of war in Europe and energy crises and so on. Credit risk is obviously something we talk about, CRE and so on. I think you're going to say that the book is extremely collateralized and low risk. So maybe I could ask you to potentially be drawn on where did the risk go first of all, and then talk about what risk you actually hold because it's inconceivable to many in the room that poor risks weren't written in a zero rate environment. Where are they today?

William Chalmers
Yeah, it's a good question. One answer to that question might be that we've been highly regulated since the financial crisis as an institution, but also as a sector as everybody will know. I think during that time, there is no doubt in my mind that as a result of that regulation, the stress test associated with the capital consequences associated with poor performance and so forth, there has most likely been a migration of risks outside of the banking sector and certainly from our perspective, at least outside of Lloyds Banking Group. Where do they lie now? I think one could conceivably look at areas of the shadow banking sector, for example. I don't know in saying that, but I do think that regulation clearly has consequences. Some of them perhaps we see on our balance sheet or rather the absence of those issues on our balance sheet today.

I think to get to the second point of your question, Jason, just to step back. The credit performance, as you say, has been very benign. I'll try not to bore you too much with various statistics, but it has been very benign. The year to date charge 850 million, about 25 basis points as you know. The Q3 charge, which is more of a market to market, I guess 187 million, which is 17 basis points. Now, once you add back in things like calibrations from better than expected unsecured performance, once you add back in multiple economic scenario charges, you're actually looking at underlying Q3 charge of more like 28, 29 basis points. But it's still on the benign end of things and below our through the cycle charge.

I think what's pleasing from our perspective is that that has been reflected in decent retail performance, both secured and unsecured. I won't go on at any further length about them, but there's a lot of detail to add as you can imagine.

Jason Napier
I didn't want to deter you from telling your story.

William Chalmers
I'll spare the audience. And then on the other hand, likewise in the commercial space as well, I mean it's been really a very benign set of metrics from the commercial side. You saw that we upgraded our guidance. It was the only piece of guidance that we did upgrade as of Q3 in terms of asset quality ratio to below 30 basis points. So below our through the cycle charge.

What's going on there? What's driving it? I think it's probably three things. One is the macro. I mean, I know it's much talked about, but the macro has not been that bad. Macro to date, and indeed looking forward, we are forecasting pretty modest GDP growth about 0.4 per cent, for example, 0.5 per cent this year and next. But it's not a downturn. It's not an actual recession if you like, at least not beyond any one quarter.

Likewise, unemployment. We're forecasting peak unemployment of just over 5 per cent. At the moment, as everybody knows, it's within the 4 per cent zone. So it's a tough macro, it's a slow macro, it's a pretty uninspiring macro, but it's not a hugely adverse or recessionary or high unemployment scenario that we're seeing, nor do we necessarily project one going forward. So I think the macro number one.

Second, high quality customer base. We talk about our customer base as being prime, and I think we would stick by that definition across the board. And then the third, it's a high quality book. So again, I won’t bore you with too many

statistics, but 43 per cent LTV in mortgages, for example, coincidentally 43 per cent LTV within commercial real estate for example. And then it's very well provisioned.

If we then look forward, based upon our Q3 macro, Jason, I'm not sure that anything much changes. I mean, I would expect naturally we won't get the kind of one-off effects that we got in Q3 in Q4, so you will see the Q4 charge go up a little bit because of the absence of those one-offs. But looking forward, I wouldn't expect that AQR charge overall to vary too much from the types of levels that we're seeing. If it does deteriorate, then I think, again, by virtue of a high quality customer base and by virtue of a high quality book, I think we're pretty well positioned. I mean, I won't repeat those statistics around the retail and the commercial books, but once you kind of get through low LTVs, high average income, £75,000 for the mortgage book for example, you're down to the provisions. And the provision, as you know, at 5.4 billion, the ECL is some 700 million in excess of our base case expectations for provisioning.

So you've got a number of lines of defences there. You've got an okay macro. But even if the macro deteriorates, you've got a high quality customer base. If that deteriorates, you've got a high quality book. And if that deteriorates, you've got a very strong provisioning position. So a lot of lines of defence. And I think from a credit quality point of view therefore, we feel pretty comfortable right now, Jason.

Jason Napier
With an eye on the clock, perhaps, well, just one last question. Slow capital demand, environment for loan growth is low, decent return on equity and so on. You have made some acquisitions, Citra and Tusker and the like. Although the dogma of the market is you should give everything back all the time, it's not abundantly clear that you're being rewarded for doing so. Are there arguments that you should be investing more aggressively or continue to be buying things to fill out the product range?

William Chalmers
Well, a couple of points really. One is, I think you're right. We're not really being rewarded for either capital generation or distribution right now. You can see it in the share price frankly. But I think all we can do is just consistently and predictably deliver it, Jason. We can’t moan too much about it. We’ve just got to put up with whatever it is. But what we can do is, as I say, just deliver consistent, predictable, reliable returns.

In terms of strategy, the strategy is first and foremost organic. It’s going to continue to be that way. The types of transactions that we have made, have been either filling in capabilities where there’s a bit of a gap, Tusker is a great example of that, salary sacrifice schemes in transport. Or alternatively scale - so we bought the Tesco mortgage book 2019 or thereabouts. Again, just a straightforward scale acquisition.

I think when we look at the overall plan, Jason, we want to and believe we can do two things, that is to say sustainably invest in the business, which frankly we have to do in order to make sure that we keep pace not just with our peers and competitors, but also with kind of nascent trends within the industry, big tech being an obvious example of those. So we have to invest and we will do so on an ongoing basis. But that investment is about sustaining those long-term capital generation numbers, Jason. So we've committed to 175 over the course of this year. As everybody knows, that implies a sustainable and progressive dividend. We've got a 15 per cent dividend growth at the interim. And then I fully expect to have an excess capital discussion with the board at the year-end.

Last couple of years, we've distributed 2 billion in each year. I won't second guess what the number will be this year. I'll await the board debate, but nonetheless, we'll have a decent excess capital debate at the end of the year, I'm sure. And so putting investments alongside, generating capital is key.

And a final point perhaps, Jason, is we also aim to clear away the kind of capital blockers between strong P&L performance, strong capital generation, and anything that gets in the way of distributing that to shareholders, we're interested in clearing up this year. We've made some progress on the pension fund. That deficit has largely gone this year as you know. That significant progress since 2019, getting rid of a £7.3 billion deficit as it was. There are still one or two bits and pieces in the way, CRD IV is one that we highlighted at Q3. We still need to do some further work on that. But as those capital blockers get cleared away during the course of this year and next, then the operating leverage in the story that starts to get delivered should deliver reliable capital generation, which as we get rid of capital blockers, will allow us to distribute more to the shareholders. And off the back of that, Jason, again, invest alongside generate capital.

Jason Napier
William, thank you very much. Thank you for joining us today, we really appreciate it.

FORWARD LOOKING STATEMENTS

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